



Greetings!

The divergence that is not

Greetings and best wishes for a happy and prosperous 2020!

2019 ended with a common refrain that the stock market does not reflect the state of the economy. While the economy is in a precipitous slide, the markets are at a new high. We sifted through some basic data points to get to the bottom of this conundrum. To begin with, the stock market may be at a new high but investor returns have been tapering off. The economy is also at or near a new high in terms of absolute GDP. That may look like a bit odd but that is true – our GDP has never been higher in rupee terms. The rate of economic growth, however, is at a multi-year low. In other words, the incremental accretion to the GDP of the country is so tepid that it does not feel like we are a growth economy. If we look at the returns from all the major indices, that is an eye opener. Stock returns have been falling.

Sample the returns from a few of the most widely followed stock indices:

Description		SENSEX 30	Nifty 50	Nifty Next 50	BSE100	Nifty Midcap	BSE 500	BSE Smallcap
Compounded annual growth rate (CAGR) (%)	15 years	13%	12%	13%	13%	12%	12%	7%
	10 years	9%	9%	11%	9%	9%	9%	6%
	5 years	8%	8%	9%	8%	6%	8%	4%

Source: Bloomberg, Spark Fund Research

The trailing annual returns over the last five years is less than that over the last 10 years, which, in turn, is less than the same over 15 years. Investor returns have been steadily falling and at 6-8% per annum, it is barely above inflation. The economic growth rate is falling and, at current levels, will hardly improve the living standards of most Indians. Thus, the point we want to emphasize is that the serious dichotomy between the market and the economy is a chimera and is based on a superficial look through.

The narrow market that is

If you call this a bull market just because we are at a new high, this is indeed one driven by an emaciated bovine. The market breadth has been horrendous with just five stocks accounting for more than 100% of the market returns over 2019 and four stocks doing the honours over the last three years.

Now, look at some basic fundamentals for the banking sector, the bellwether sector in the market:

Company Name	PAT – CAGR (2014-2019)	Loans – CAGR (2014-2019)	GNPL - 2014	GNPL - 2019
Axis Bank Ltd.	-4.4%	16.6%	1.4%	6.0%
Bank of Baroda	-26.1%	3.4%	3.0%	10.3%
HDFC Bank Ltd.	20.7%	22.0%	1.0%	1.4%
ICICI Bank Ltd.	-13.4%	11.6%	3.1%	7.8%
Kotak Mahindra Bank Ltd.	23.2%	31.1%	2.0%	2.2%
LIC Housing Finance Ltd.	13.0%	17.6%	0.7%	1.5%
Muthoot Finance Ltd.	21.9%	9.8%	1.9%	2.7%
State Bank of India	-26.7%	12.6%	5.1%	7.9%
The Federal Bank Ltd.	9.1%	20.5%	2.5%	3.0%
Yes Bank Ltd.	1.2%	34.1%	0.3%	3.3%

Company Name	PAT – CAGR (2016-2021)	Loans – CAGR (2016-2021)	GNPL - 2016	GNPL - 2021
Axis Bank Ltd.	11.9%	14.3%	1.8%	4.6%
Bank of Baroda	-218.4%	14.4%	10.6%	8.6%
HDFC Bank Ltd.	20.5%	19.9%	0.9%	1.5%
ICICI Bank Ltd.	9.8%	12.3%	6.0%	5.7%
Kotak Mahindra Bank Ltd.	16.1%	17.8%	2.4%	2.3%
LIC Housing Finance Ltd.	11.9%	16.4%	0.5%	2.6%
Muthoot Finance Ltd.	29.5%	12.8%	2.9%	2.8%
State Bank of India	27.3%	13.0%	6.7%	5.9%
The Federal Bank Ltd.	34.6%	20.0%	2.9%	3.1%
Yes Bank Ltd.	-18.7%	19.7%	0.8%	8.4%

Source: Ace Equity, Spark Fund Research



It is clear that the profit share in the sector is getting increasingly concentrated. This is a winner-take-all economy. Market performance has mirrored the flux in the economy and the consolidation of market share and value migration. If you do a similar exercise in other major sectors such as auto and consumer, the results would be directionally similar.

These observations have important takeaways for us as long-term investors and have indeed influenced our thinking in allocating capital. The gist of the lessons is:

1. A weak economy is not a shrinking economy and a strong market index does not equate to robust investor returns
2. In a weak economy, strong companies gain share and such consolidation is a trend, which is global in nature as well

Where is the disconnect

It is entirely in the fitness of things that money has gone after growth and performance. We have seen a higher financialisation of savings and a higher share of mutual funds in domestic financial savings over the last five years. This has upset the valuation paradigm in a market where the universe of investible stocks has been narrowing. Somewhere in the process, the market and analysts have shifted their focus from one-year forward earnings to two-year forward earnings to justify higher valuations. Beat of quarterly earnings estimates on low-balled expectations has become a sufficient reason for expansion in P/E multiples. Never mind that the higher multiple now sets the bar higher for all time to come.

The quality premium has become the new mantra and has become an excuse to seek comfort when uncomfortable questions are posed. Price performance driven by liquidity has fed into this process and we have come to a pass where price in itself has become a determinant of fair value. Investors now look at reasonably valued stocks with suspicion as that has now become a red flag. The tail is indeed wagging the dog.

All good things come to an end and excesses have no happy ending. When a stock or a group of stocks trades at a two-year forward P/E of 40+ with an earnings growth of 15% built in, that usually spells trouble. Or when a stock or sector trades at a few standard deviations higher than their own mean valuations. The room for disappointment gets as narrow as the market breadth. A weak demand environment ipso facto means that the proverbial Damocles sword is hanging in there to come down hard anytime. We reckon that such risks have been building up over the last few quarters and we may well be near an inflexion point here.

On the other hand, many stocks are trading at well below their own mean valuations and at what may be considered good value. This has proved to be a treacherous value trap at times. The key to tackling this is not to take apparent (but non-existent) safety in the so-called quality premium. We believe that looking at individual stocks in terms of intrinsic business model resilience and separating cyclical from structural challenges may give better answers.

What is in store for us in 2020

2019 started with fears over political instability. That fear proved to be completely off the mark. 2020 starts with fears over economic uncertainty. While the data looks bleak, that is how the bottom of the cycle is supposed to look like. As the year goes by, the conditions for a cyclical recovery should gather steam. The reform story in India has been consistent in that reforms have only happened when there is a lack of options. That said, the structural factors driving the slowdown will ensure that the recovery will take time to develop roots.

We do not believe that the recovery tide will lift all boats. While our investment positioning expects rotation in performance from the over-extended, richly valued market favourites to stocks that will drive the economic recovery, the case for a broad-based market performance with indiscriminate participation is not strong. Firstly, mid/small caps need economic tailwinds to perform and the momentum is likely to remain weak for the next few quarters, though the direction could change. Secondly, we do not see most mid/small cap valuations at a discount that cover the risk sufficiently, given that price erosion has been accompanied by earnings downgrades. Thirdly, the ongoing market share and profit consolidation trend is set to continue.

Where are we positioned

All year in 2019, the above thoughts have guided our process. We have constructed portfolios with a view to striking a golden balance between growth visibility, sustainability and valuations. Broad contours that have guided our stock selection process have been:

1. Business model sustainability
2. End-market potential over a 3-4 year horizon



3. Management credentials in terms of capability
4. Alignment with shareholder interests
5. Valuations in relation to earnings growth and historic range
6. Stock liquidity
7. Cyclical challenges in stocks have been no deterrent for us
8. PSU stocks have been acceptable for us if the business is good and direction is right

The end result has been that we have ended 2019 with nearly 50% allocation to mid/small caps in our Flexicap strategy for portfolios where investment level has gone well beyond the 90% mark. Our preference has been for larger mid/small caps, besides being careful about balance sheets and managements.

We have placed our bets on names that will benefit from the economic recovery. The focus has been on companies that have executed well in a tough environment. Thus, an L&T or an Ultratech Cement have made the cut. They are not trading at the higher end of their valuation range. They have not seen an erosion in their competitive position. They have not seen even an erosion in their profits. They have underperformed in 2019 due to the economic recovery being a no-show. They are not laggards in their business. The impact has been on their price multiples due to the adverse sentiment around the near-term outlook on the economy.

We continue to like a few names in banking, which are amongst those that are part of the market share and profit consolidation story. Most PSU banks remain capital constrained and we see no change in this. Most NBFCs are likely to be structurally challenged with no access to capital. This sets the stage for an accelerated gain for the financials with a strong balance sheet and access to funds. In banking, 2020 may well continue right from where 2019 left us.

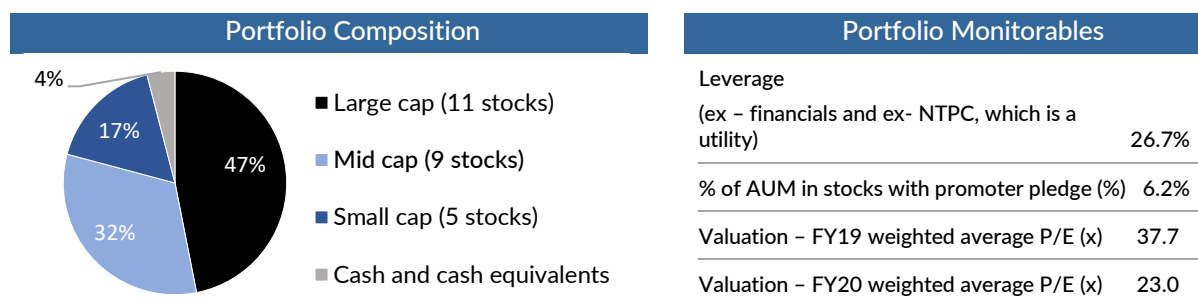
Our midcap and select exposure to small caps have been in names that have a leadership position in their niche. In a sector such as banking, these are names which have navigated the cycle with their balance sheet intact and are mispriced. We have some allocation to the theme of clean energy but here again, in companies that have healthy cash flows and reasonable valuations. Finally, our reform bets have been in a few value PSUs wherein we see valuation and dividend yield support, coupled with strong balance sheet credentials.

As we go into 2020, we believe we have a balanced portfolio with several triggers such as reforms, economic recovery and consistent earnings trend. 2020 should prove to be a watershed year for India and we hope to keep abreast with the progress through our investments.

Warm regards,
P Krishnan (CIO) and Team Spark Fund



Portfolio composition



Note: Represents portfolio of a typical investor onboarded in February 2019 when the strategy commenced; actual portfolios may vary depending on timing of entry into the strategy. Note: Market cap as per SEBI guidelines

1. Overall allocation to stocks in portfolios has been stepped up during December. While markets may be primed for a correction from overbought levels, we have seen over the past year that timing the market has not yielded much alpha
2. The portfolios are well diversified across market cap and across companies with different business drivers and from different sectors
3. We continue to pay attention to liquidity of stocks in our stock selection process. The traded volumes in our holdings continue to show encouraging trends.

Disclaimer

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